

Performance Management: Analyzing and Monitoring Charter School Finance

Part 1

TAMMIE KNIGHTS:

Good afternoon everyone (or good morning for some folks out there). My name is Tammie Knights from the National Charter School Resource Center, and I'm pleased to welcome you to the webinar Performance Management: Analyzing and Monitoring Charter School Finance.

The Resource Center is funded by the Department of Education's Charter Schools Program and serves as a national center to provide resources, information, and technical assistance to support the successful planning, authorizing, implementation, and sustainability of high-quality charter schools; to share evaluations on the effects of charter schools; and to disseminate information about successful practices in charter schools.

I want to quickly remind you about our webinar platform. You can listen to the audio portion either through your computer or over the phone. If you do join by phone, please mute your computer speakers to prevent an echo effect as we are recording this webinar for future use. If you are not prompted to enter your phone number, please dial the number that is listed in the chat. For any questions you have, please enter them in the chat throughout the webinar.

For your information you will find the PowerPoint to today's presentation, as well as an additional resource, in the box located directly under the chat. If you click on that—hit Download File—another Web browser pops up for you to be able to download the file.

As I said, as a reminder, the webinar is being recorded, so to ensure audio quality, I have muted all of the participants. If we need to come to a time for you to be able to speak

[while] being in the chat, you can press *6 to unmute and speak over the phone.

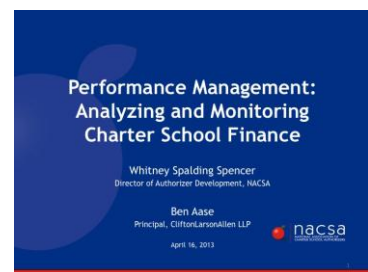
Today's webinar will feature Whitney Spalding Spencer, who is NACSA's [the [National Association of Charter School Authorizers](#) (NACSA)] director of authorizer development, and Ben Aase, principal at [CliftonLarsonAllen LLP](#). [This is] an interactive presentation where we'll have several questions to ask you as an audience and when those come up, we will put a question over the PowerPoint presentation for you to be able to participate, and then we'll go back to the presentation. And with that said, I will turn it over to Whitney and Ben.

WHITNEY SPALDING SPENCER:

Thanks, Tammie. As Tammie mentioned, this is Whitney Spalding Spencer at the National Association of Charter School Authorizers, and we're pleased today to be able to share with you our core performance framework. I'll talk a little bit more about what that is in a moment.

To start with our agenda for today, we're going to give an overview of the core financial performance framework that NACSA has created and in which CliftonLarsonAllen has certainly been a key partner. Sort of through that overview and later in the webinar today, we're going to talk about a case study of an actual charter school's finances and talk about, you know, based on what we've learned about the performance framework, how would we assess this school's quality? And then we'll talk more about actually implementing the performance framework.

Once you've assessed the school's quality based on the performance framework measures, how do you follow-up, how do you monitor the school's performance, and how do you ultimately make decisions about what to do with that school?

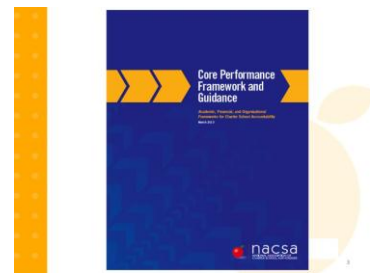


Slide 1



Slide 2

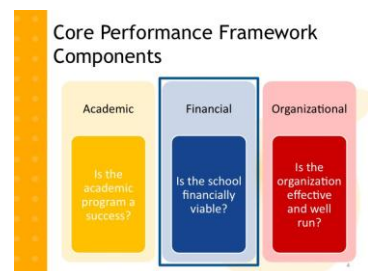
This is NACSA's core performance framework and guidance. This is a resource that we recently published—really only just a few weeks ago—that we were able to create through a federal grant. We are a national leadership grantee in each of those three areas. But we find that really the core performance framework, particularly the financial piece, is important not just to authorizers but is useful to anyone who is of value [inaudible]—whether it be at the school level, an authorizer level, or another position.



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The core performance framework and guidance, just to note, is not currently in the File Share section of the webinar, but we would love for you all to get a copy of this, so we will send an e-mail following the webinar with information on how to request a copy, or you can e-mail, if you remember it, otherwise we'll email you, stacyf@qualitycharters.org, so that's stacyf@qualitycharters.org. And if you didn't get that down, we'll shoot you an e-mail later to let you know how you can get a copy of this resource which we're going to walk through today.

The core performance framework actually has three sections. The performance framework, just to step back a little bit, is an accountability tool that every authorizer should have that allows them to set clear, transparent expectations for the charter schools in their portfolio to let them know how they have to be performing in order to be renewed and to continue operating. That accountability system needs to include three sections: academic, financial, and organizational performance. Organizational: "Is the organization effective and well run?" Today we're really going to focus on that financial piece.



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Now I'm going to pass it over to Ben, who is going to walk through [it] in a little bit more detail.

BEN AASE:

Thank you, Whitney. And before we do that, Tammie, can we go to the polling question number one? I'm interested in finding out who is in the audience here. [pause]

TAMMIE KNIGHTS:

Yes.

BEN AASE:

Thank you. [pause]

TAMMIE KNIGHTS:

You seeing the results there, Ben?

BEN AASE:

I am; good. Can you expand the pod a bit so I can see them a little bit better?

TAMMIE KNIGHTS:

That's what I'm trying. [pause]

BEN AASE:

Okay.

TAMMIE KNIGHTS:

If people are there, I can broadcast it. [pause]

WHITNEY SPALDING SPENCER:

It looks like most people—there it goes. [pause]

BEN AASE:

You able to bring that back up, Tammie?

TAMMIE KNIGHTS:

Sorry. Yeah, there we go.

BEN AASE:

Okay.

TAMMIE KNIGHTS:

There we go.

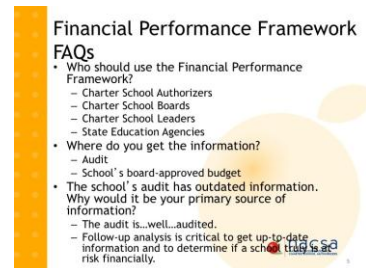
BEN AASE:

All right; excellent, thank you. Okay. We've got a pretty good mix of folks. Some charter school leaders, some charter

school authorizers, other school employees, a small number of SCA representatives it looks like, and a whole bunch of other people too. This is great, that's excellent, and it does help quite a bit with context as we move through today's material, so thank you.

A few, just sort of ground-setting frequently asked questions that we want to make sure that we cover here before we dive into the framework itself.

- Who should use the financial performance framework?
- Where do you get the information?
- And in that last point there, which we'll dig into a bit later, in terms of using schools audited financial statements, it's a source of information. So they'll be context throughout this discussion addressing all of these questions.



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But [I] just want to start by saying that, well, the primary purpose of the framework is certainly to assist authorizers in developing and implementing their own frameworks. I would suggest that its content and approach can be useful from another perspective, a number of perspectives, whether you're a school leader, I'd say a CFO [chief financial officer] or a business manager perhaps, a board member, a state agency representative, or another individual who's involved in or impacted by the results of a charter school. Whatever your perspective, the framework ultimately really provides a tool that recognizes schools that are currently in or starts to mature in more [inaudible] standards make their way into the taxonomy. This can also be a good tool for championing your financial successes too.

The framework was derived through a review of model authorizer practices, charter school lender guidance, and expertise drawn from the field. You'll see in the full framework and guidance, if or when you receive a copy, a number of folks have their hands in this work. CliftonLarsonAllen is just one of the many organizations that contributed to this.

As a point of reference, CliftonLarsonAllen is a national public accounting firm. We're about the 10th largest firm in the country, and we do quite a bit of work with state and local government agencies, quasi-governmental entities, K–12 districts, charter schools, and basically sort of up and down the P–20 education horizon. We've been a long-time partner of NACSA and are very proud of the work we've done here.

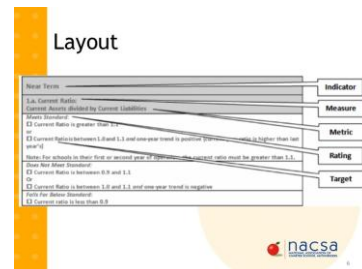
The framework does not specifically mirror any single source of information or perspective. It was created to provide a clear picture of a school's past financial performance, its current financial health, and [its] potential financial trajectory. Using the framework, I want to say this upfront, does require information sourced largely from independent annual financial audit[s] that use, ideally here, accrual-based accounting. Cash-based audits within this framework will prove problematic. And we'll get into some of the supplemental information that is useful to both using the framework as is and that is also, I'd say, instrumental in additional analysis, follow-up, and action or decision making.

This is of today's webinar. You don't have to go get these things right now. We've got a small case study; it's embedded here as a PDF, but I can tell you that all of the information that we need to engage in that through this webinar is included in basically a one page summary. But, otherwise, you'll hear various financial statements referenced throughout this webinar: audited balance sheets; income statement; statement of cash flows; notes to the audited financial statements; board-approved budgets with enrollment targets; actual enrollment information; and also some supplemental information, such as annual debt schedules; and information such as that.

I just want to say that throughout this webinar and throughout the guidance, financial statements are referred to in the common for-profit nomenclature. Statements reported in nonprofit or governmental audits may use slightly different

names depending on the financial statement, but there's also in the guidance a good table that helps you work through the differences, depending on how audits are performed within your state.

With that, the framework engages both near-term financial health and longer-term financial sustainability and includes five main levels of information that you see broken out on the screen here: indicators, measures, metrics, targets, and ratings. I want to take a minute [inaudible] categories of financial performance. Basically, broken down into two categories: near-term and longer-term sustainability.



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Right below that within each indicator are a number of measures. Now these are the general means to evaluate an aspect of an indicator. The example you see here is current ratio. Eight measures are used in the framework, current ratio being one, unrestricted day's cash, enrollment variances, debt default, total margin, debt-to-asset ratio, cash flow, and debt service coverage ratio. So those are the eight measures within the framework that we'll also walk through here today.

If we move down one level, we then get to metrics, which is basically an articulation of the method for quantifying a target. In this example, current ratio is equal to the school's current assets divided by its current liabilities. So [it] basically provides the math as logic behind the measurement.

Moving down again to targets. Targets are the thresholds that signify success in meeting the standard for each specific measure. To this example, a current ratio of greater than 1.1. Each target and formula is detailed in the framework, and the basis for forming many of the targets was on industry standard, at least to the extent that they exist. Other financing and funding environments have been considered and included in instances where we may see moves away from an industry standard where necessary. At the end of the day, whatever your perspective, whatever

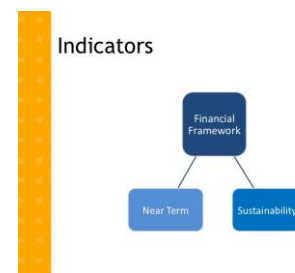
your role, this framework ought to serve as a good jumping off point for customization as you see fit.

Let's move into ratings and talk about those for a moment. For each measure, a school receives one of three ratings based on [an] evaluation of the established metrics:

- **Meet standard.** In this case the school's performance does not signal a financial risk to the school and meets the authorizer's standard.
- **Does not meet standard**—and you can see these layered vertically here on the table. Does not meet standard. In this instance, the school's performance on this component signals a financial risk to the school and does not meet the authorizer's expectation.
- **Falls far below standard.** In this instance, the school's performance on this measure or target signals a significant financial risk to the school and also does not meet the authorizer's expectation.

I'd like to keep going here. The framework includes two indicators or general categories to evaluate a school's financial performance. The first that you see on the left are near-term indicators. This portion of the framework, which we'll walk through first, tests the school's near-term financial health and is designed [inaudible] schools that fail to meet the standards may currently be experiencing financial difficulties and/or may be at high risk for financial hardship in the near-term, requiring additional review, corrective action, or analysis whether you're an authorizer or another vested party.

In the second group of indicators—sustainability. The framework also includes long-term financial sustainability measures that are designed to depict a school's financial position and viability over a greater length of time. Schools that meet the desired standards demonstrate a low risk of financial distress in the future, while schools that fail to meet the standards may be at high risk for financial hardship in the future.



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Now are there any questions before we dig further into the measures in detail?

I'm going to take a look, and the way I'd like to handle the questions [is as follows]: I'm going to try to field those which are certainly directly related to the material at hand, and I want to acknowledge we received a number of questions in advance of the webinar as well. To the extent that I can speak to those in the context of the framework here, I will. As an alternative, I'd like to suggest that for those we don't address during the webinar itself that my team perhaps composes some written responses and can distribute those to the full group as a follow-up takeaway to this webinar as well.

I've got a question here about the overlap between indicators in the near-term category and [the] sustainability category. And I guess my short answer to that is, yes, there is some overlap. Now, it weighs, and they're also designed such that let's say a school is financially healthy in one measure, but if you were to look at that measure alone or perhaps a couple of measures, you may miss something. So they're complementary and overlapping in this sense that they do provide a pretty good comprehensive viewpoint of a school's financial health and are intentionally designed to have some of those backstopper or fact catches that you might otherwise miss.

Well, let's get started with the near-term measures. Now, I do want to refer you to—if you look down in the File Share portion of the screen there—there's a document called CLA Case Study, and what you'll see here is a one-page document. We're going to keep this pretty simple, recognizing that we're somewhat limited engagement with a webinar format. But what you've got here is basically a summary of key financial information for a school, and I'm going to call this school the Academy for Technical Education, let's say. And just starting at the top I want to orient you just briefly. You've got three years of financial

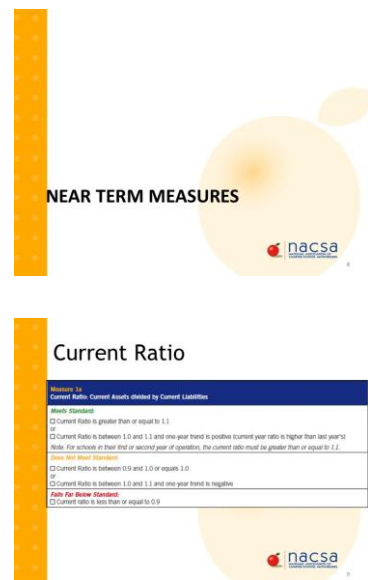
information, with the most current year in the left-hand column, in this case FY or fiscal year [20]11, and in fiscal year [20]10 and fiscal year [20]09.

Starting at the top, you've got some balance sheet information, [which is] comprised of the few main areas of assets, liabilities, and net assets, with each row also lettered. And then below that just a few top line excerpts from this school's statement of activities or income statement: total revenue, total expenses, and change in net assets. And then down at the bottom under the heading analysis, this is where you'll see the measures that we're going to walk through, both calculated—well, basically, calculated here for each of the fiscal years. That's where the financial results up above feed into the analysis at the bottom, which then ties to the measures within the financial performance framework.

I'm going to reference that in very [inaudible]. Near-term measures, we're going to start with those.

The first is current ratio, which measures a school's ability to pay its obligations over the next 12 months—over the next year. More specifically, it's defined as the relationship between a school's current assets and current liabilities. This information is sourced from the school's audited balance sheet.

A current ratio greater than 1.0 indicates that the school's current assets exceed its current liabilities, thus indicating an ability to meet its current obligations. This is a very common, key fundamental financial performance indicator—really across a number of sectors. A ratio of less 1.0 indicates that the school does not have sufficient current assets to cover its current liabilities and is not [inaudible] for a current ratio is that it should be a minimum of 1. That's at least what you may hear quite often in terms of norms or standards. Now, that said, an upward trend of a current ratio that is greater than 1 indicates greater financial health, hence the greater than or equal to 1.1 target to meet standard, or a



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school maintaining a current ratio between 1.0 and 1.1 but with a positive [inaudible] aspects or multiyear measures that help compliment and round out the perspective on financial health. You then see below corresponding boundaries and trend implications for not meeting standard. And lastly there falls far below standard. Excuse me, the current ratio of less than or equal to 0.9 is considered a fall far below standard.

Here under the Analysis Section, you can see it pulled down the math from up above and ran a current ratio for both the current and the two prior years. So I want to ask you, go ahead using the polling tool, what do you think? Does the school meet standard, not meet standard, or does it fall far below standard? [pause]

The results are pouring in. Thank you, folks. [pause] All right; I'm going to go ahead and broadcast these results.

The standard actually by a pretty long shot is its current ratio in each of the last three years is well over that 1.1 threshold, so 4.57, 4.10, and then 3.03 for the past three years, respectively. Thank you all for taking a poll there.

Thanks, Tammie. I'm going to keep us moving. We're going to hit on some additional metrics here.

Number two, unrestricted day's cash. This basically tells you how many days a school can pay its expenses without another inflow of cash. You'll need your audited balance sheet and income statement for this. I'll also want to note that in the calculation there, you'll see that depreciation expense is removed from the calculation because it is not a cash expense. That's the explanation there. When we're talking about cash, we only want to consider cash expenses.

The framework uses at least one month of operating expenses—cash on hand as a standard for [a] minimum measure of financial health. Now that said, due to the nature

| Unrestricted Days Cash | |
|---|--|
| Formula: $\frac{\text{Unrestricted Day Cash: Unrestricted Cash divided by (Total Expenses minus Depreciation Expense) / 365}$ | |
| Priority: Standard | |
| CF: 400 Days Cash | |
| CF: | |
| CF: Between 30 and 400 Days Cash and one year trend is positive | |
| Note: Schools in their first or second year of operation must have a minimum of 90 Days Cash. | |
| CF: One Year Trend Positive | |
| CF: Days Cash is between 15-30 days | |
| CF: | |
| CF: Days Cash is between 30-400 days and one year trend is negative | |
| CF: Fall Below Standard | |
| CF: Lower than 15 Days Cash | |

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of charter school cash flow and the sometimes irregular receipts of revenue, a 60-day threshold was set for schools to meet the standard. Still, I should say, schools showing a growing cash balance from prior years and then have enough cash to pay at least one month expenses also meet the standard. Finally, if a school has fewer than 15 days of cash on hand, it will not be able to operate for more than a couple of weeks without another cash inflow. It could be at risk for more immediate financial difficulties.

If you take a look at our case study again, the Academy for Technical Education, and you look down at the bottom of day's cash, how's our school doing? [pause]

Hmm, Tammie, it looks like the poll is showing it's closed for some reason. Got a solution on that? There we go, now they're coming in. Thank you. [pause]

All right; excellent. Let's go ahead and just broadcast those results. Looks like folks are zeroing in: You're right; [the] school definitely meets the standard. We're starting with short-term assets relative to short-term debt. We know that they've got a good volume of cash on hand, so we're starting to be able to understand and even tell the financial story underlying this particular school. Thank you.

WHITNEY SPALDING SPENCER:

Ben, before we move on, we've got a question on—if you remove noncash expenses from the unrestricted day's cash calculation?

BEN AASE:

Yes. If you've got other noncash expenses, really you do just want to get at cash requirements, right? So, yes. That's a great question, a great clarification there. Thank you.

Enrollment variance; this a point where perhaps we depart from traditional financial statements, just a bit as we look at these measures, but it's a very important one, and it's given rise to a lot of lively discussion in different states and environments where we've introduced this framework. But at the end of the day, it is, I believe, a very key measure. It tells you whether or not a school is meeting its enrollment projections, which, as most of us know, is often the key driver of revenues and financial sustainability. Enrollment variance, which is intended to measure and depict actual versus projected enrollment, is [inaudible] to make sure to capture early in the school year to the extent possible.

| Enrollment Variance | |
|---------------------|---|
| Standard 11 | Enrollment Variance: Actual Enrollment divided by Enrollment Projection to Charter School Board Approved Budget |
| Measures | Enrollment Variance |
| 11.1 | Enrollment variance equals or exceeds 95 percent in the most recent year |
| 11.2 | Enrollment variance is between 85-95 percent in the most recent year |
| 11.3 | Enrollment variance is less than 85 percent in the most recent year |

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Now, I do want to recognize the schools, let's say if you then five years old, may have greater fluctuations in their enrollment numbers because they're still establishing themselves within their community. But that being said, mature schools with large, unexplained enrollment fluctuations may be in financial distress if they're unable to adjust—

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BEN AASE:

—[enrollment] variances not only a way to evaluate a school's financial health but also to monitor how savvy the school's board and management are at forecasting. While enrollment variance is a primary measure of financial health, it can also be seen as a secondary measure for organizational aptitude; and I think this is actually probably a good point as well to just speak briefly to the, as intended to. gauge and measure financial health, financial position, and financial performance from a financial standpoint.

This is the one measure that starts to get into [inaudible] questions of financial management, but the vast majority of things you may be interested in about how a school manages its finances and the extent to which those support a quality operation are really going to be bound within the organizational component of NACSA's core performance

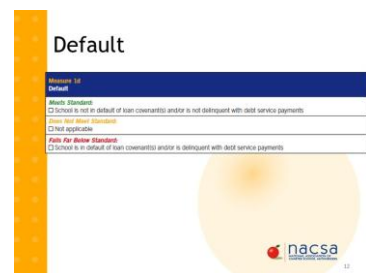
framework. For the study school, we don't have actual enrollment information for this, so unless there are any specific questions about this measure, we'll keep moving.

I do see a question here from Brian Flannerer, an observation really, which is that it seems like the variance might be 5 percent, 15 percent, et cetera. I do agree with you; I acknowledge that, Brian. The variance, if you were to say, the variance could or should be measured perhaps in the variance from 100 percent, if you will, so you are correct that would basically be the corollary if measured a bit differently there.

But at the end of the day hopefully, [you'll be able to] tell this is a simple measure of whether or not a school is meeting its debt obligations or perhaps its debt covenants.

I do want to just say upfront, sort of a big picture comment, when we talk about meeting debt obligations or covenants, for the most part we're generally not talking about whether or not the school is making its ongoing payables—small bills of that nature. We're really interested in sizable debt that, let's say, is material to the financial health and condition of the school, so think about things like mortgages, bond obligations, or other significant capital-related debt instruments. And, also, I wanted to acknowledge that because of the variation in statutory limitations on schools holding debt, each authorizer should determine the exact application of this definition. But that being said, knowing whether or not a school is meeting and current on its debt obligations and covenants is certainly an important thing.

So, and the last sort of nuance here, you may consider a school to be in default only when it's, let's say, not making payments on its debt or—now, for this one you're going to need to look at the notes to a school's audited financial statements. It will not be embedded within these numbers, and this is where reading those notes, which is a good habit and a good practice to begin with, will really help to uncover some determination on this measure. For our case study



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school, because we summarized top-level financial data into a one-pager here, we didn't send you a full notes to financial statements and have you go digging for any debt default. Unless there are questions, I'd like to move us on to the next metric.

We're through the near-term measures: we started to paint a picture of this school's financial health; we've taken a look again at current ratio of day's cash, and then we've discussed a couple of other metrics that make up those near-term indicators. It's now time to turn our attention to the sustainability measures: longer-term measures designed to gauge a school's financial position and viability over time.

First up is total margin, which measures whether or not a school is living within its available resources on an annual basis or, more specifically, whether a school operates a surplus. Schools can operate at a deficit for a sustained period of time without eroding their financial health. You'll note that the framework uses two calculations: One, a single year total margin and the other an aggregated three-year measure. The latter is really helpful for measuring the long-term stability of the school by smoothing the impact of single-year fluctuations in margin.

In terms of a basis for the target level, preference in most industries is that total margin is positive, but organizations can and do make strategic choices to operate at a deficit for a given year in order to incur, perhaps, large operating or other planned expenditures. So you want to keep that in mind.

The framework's targets do allow for this flexibility over a three-year time horizon but do require a positive total margin for the most recent year in order to meet the standard. And then lastly, a margin in any year of less than negative 10 percent, and that is 10 percent of total revenues, or an aggregate three-year total margin less than or equal to negative 1.5 percent falls far below standard. Again, allowing for some flexibility in terms of time horizon, in terms



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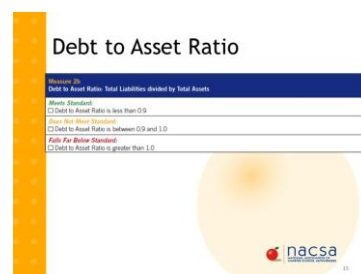
of financial performance over that time horizon, and really putting a fairly nuanced lens on this particular measure. Because of the trend component of this measure, you'll also need three years of audited income statements to run the calculations.

Let's turn back to our case study for a moment here, and here's where you'll really take a look at that statement of activities section there, which feeds in down below to the profit margin calculation. How does our school do against the standard? And, Tammie, if you could please, cue up number four there. [pause]

All right; thank you. We'll broadcast the results here, and this one I'm not surprised by. We've got the more of a mix of perspectives or respondents here in terms of whether or not the school meets the standards, although it looks as though the greatest number of participants here believe that the school falls far below the standard, which is actually correct, so less than or equal to negative 1 percent. They've been running a deficit for the past three years: Three years ago about 9 percent, then 8 [percent], and then most recently 14 percent, so that really gets to the latter element of the falls far below standard in that the school's most recent total margin is less than negative 10 percent. Whatever my perspective might be, I'm going to want to know what the story is behind that deficit, recurring deficit.

Any questions? All right. Let's keep going then. We're going to start to get into some additional interesting metrics here.

So number six, debt-to-asset ratio, which compares, basically at the end of the day, what a school owns against what it owes or, in other words, the amount of liability [inaudible] school relies on borrowed funds to finance its operations. You'll need a school's audited balance sheet for this particular measure, and as we move through the standards, a debt-to-asset ratio greater than 1.0 is a generally accepted indicator of potential long-term financial issues, as really, fundamentally, the school owes more than



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it owns, which is a pretty risky financial position for an organization to be in. A ratio of less than 0.9 indicates a financially healthy balance sheet—both in its assets and its liabilities—and also, by extension, its equity or net asset accounts.

Let's see. How is our school doing? If you take a look, the third calculation down under the analysis section, debt-to-ratio against the standards here, does it meet standard, does it not meet standard, or does it fall far below standard?

TAMMIE KNIGHTS:

Ben, it looks like there's been several questions in the chat that maybe we could take a look at.

BEN AASE:

Yeah. [pause] [The] results are in, and it looks almost unanimous—school meets the standard, and you are correct. It looks good, looks as though the school really shows little leverage or reliance on debt to finance its operations. Let me pause here and take a look at some of these questions that are floating across the webinar screen here.

Interaction between operating and capital budget in evaluating margin. In evaluating margin, you would look at operating budget or operating results, which, and when I say that should include the current, let's say the current portion of any long-term or capital spending implications. So you might have a capital budget that's multiyear and then within your current [inaudible].

Let's see. Would the ratio be different if the school owned its own real estate? The ratio itself—the calculation and the results—could be different, but it should still give you a decent capture and a good reflection of debt-to-asset ratio, so I would not necessarily advocate that the standards necessarily change. But this can be and should be applied in circumstances where schools do or do not own their own real estate.

Now, let's see. I see you have a question about taxonomy and language, which certainly comes up at a lot of points. Brian here points out, someone pointed out to me that schools don't make profits but accumulate surpluses or deficits, so we have to start calling it a surplus margin.

I would welcome whatever language, whatever taxonomy sort of works for your culture and your organization. I don't know that there's a specific answer to that question per se, except that I tend to use the language interchangeably, but you want to be cognizant of your audience, their context, their understanding [inaudible] that's growing every year.

There is—I mean at the end of the day—you basically just want to know what the story is behind that. Why is it that the school is moving away from using its own assets or equity as a capital structure for the organization and why is it taking on more debt? There's good debt and there's bad debt. At the end of the day, you want to make sure your school is appropriately using and growing those debt instruments that are actually going to help the organization—sort of prosper in a positive way versus taking on debt for the wrong reasons. Those are sort of the top-level fundamental questions that I would probably ask at the outset.

Let's see here. [pause] Ah, good question about depreciation expense being removed in calculating profit margin. I would advocate that no. If you were looking, if you were really trying to get at a cash measure, I might say yes, but, generally speaking, industry standards, whether you're talking about, let's even just expand to the nonprofit sector, most financial advocates would say that both budgeting for and considering depreciation expense, even though it's a noncash expense, is a healthy practice because that's also a way in which you can build up accumulated capital to then help reinvest in some of those assets that are depreciating over time. So I think from my standpoint and our firm's standpoint and the number of folks in the industry, that you want that margin to include or allow for depreciation for that reinvestment.

If it's all right, I'm going to—

WHITNEY SPALDING SPENCER:

Ben, actually, there was one more question I think we missed that I believe was probably related to the total margin measure. What do we do if we don't have three years of audited statements yet?

BEN AASE:

Oh, great question. If you do not have three years of statements, and I think the conversation, the conversation is just a little bit different, and you're less able to make, perhaps, draw the same conclusions or tell the same depth of story. But it serves as a starting point for our conversation about what that trend might look like going forward. So I guess that would be my answer to that question.

WHITNEY SPALDING SPENCER:

I think what the framework also incorporates—actually says in order to meet the standard—schools in their first or second year of operation have to have a positive total margin. In those early years, you want to make sure that it's positive, even though you can't calculate [it] over the three-year period.

BEN AASE:

Exactly. I am going to... I'd like to move us through the material. I see a question here from Jacquelyn, which is a great question: "How do you evaluate or implement this kind of framework in the context where you might have a management contract or a for-profit company that has its own sort of set of books, et cetera?" That's a great question, somewhat of a complicated one. What I'd like to do, Jacquelyn, is move through the material and if, for some reason, we aren't able to get into a discussion here—we've certainly worked within that context, and we've worked in how you might adapt for that.

All right; just two more to go. Cash flow: This indicates a trend in a school's cash balance over a period of time. It's similar to day's cash on hand but really from a longer-term vantage point. Since cash flow fluctuations from year-to-year can have a long-term impact on a school's financial health, this metric assesses both multiyear cumulative cash flow as well as annual cash flow. Again, offering you that complementary, slightly deeper perspective by looking at not just a current period or [a] past, prior period but looking at trends over time.

| Cash Flow | |
|--|--|
| $\text{Multi-Year Cash Flow} = \text{Year 3 Total Cash} - \text{Year 1 Total Cash}$ $\text{One-Year Cash Flow} = \text{Year 2 Total Cash} - \text{Year 1 Total Cash}$ | |
| Where Standard: <input type="checkbox"/> Multi-Year Cumulative Cash Flow is positive and Cash Flow is positive each year. <input type="checkbox"/> Multi-Year Cumulative Cash Flow is positive, Cash Flow is positive in one of two years, and Cash Flow in the most recent year is positive. <input type="checkbox"/> Multi-Year Cumulative Cash Flow is positive, but trend does not "Meet Standard". <input type="checkbox"/> Multi-Year Cumulative Cash Flow is positive, but trend does not "Meet Standard". Calc For Below Standard: <input type="checkbox"/> Multi-Year Cumulative Cash Flow is negative. | |

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The preferred result is pretty basic. It's greater than zero, right, indicating increasing financial health and [a] positive development of cash balances. You will need three years of audited balance sheets to run your calculations, so I would offer the same response in terms of depending on what year the school might be. You're starting to build that body of data and evidence, so go back as far as you can, but, at a minimum, you've also got complementary cash measures in here. If this is the case, in which the near-term indicators are probably going to be more relevant and useful for your particular situation.

Let's see; I want to just ask the question. If we go back to the case study here, "Does our school meet the standard, does it [inaudible] section?" [pause]

[Let's] take a look at the results here. Okay. Three quarters of you feel that the school meets the standard, and I would agree with you. Even though the school saw a negative cash trend in the first of the three years measured here, its multiyear cumulative cash flow is positive, and cash flow is positive in two of the three years. And also, I should say, cash flow in the most recent year is also positive. So this school does meet standard in that regard.

Last but not least, debt service coverage ratio. This measures whether or not a school can pay [inaudible]. Now note that depreciation expense is added back to the net income within the calculation because it is a noncash transaction, and interest expense is added back to the net income because it is one of those [things] that the school is wanting to be able to or trying to pay, which is why it's included in the denominator there. You are going to need a few data sources for this one.

| Debt Service Coverage Ratio | |
|-----------------------------|---|
| Formula: | $\text{Debt Service Coverage Ratio} = \frac{\text{Net Income} + \text{Depreciation} + \text{Interest Expense}}{\text{Annual Principal, Interest, and Lease Payments}}$ |
| Rating: | <input type="checkbox"/> Debt Service Coverage Ratio is equal to or exceeds 1.1 <input type="checkbox"/> Debt Service Coverage Ratio is less than 1.1 <input type="checkbox"/> Not Applicable |

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Net income or total margin you'll find in the audited income statement. Depreciation expenses you'll find on the audited cash flow statement. And interest expense you'll find on either the audited income statement or the cash flow statement. Annual principal and interest obligations would, in most cases, need to be provided by the school. It's a piece of data that oftentimes you will not necessarily find within the audit and financial statements itself.

Debt service coverage ratio is pretty commonly used as a debt covenant measure across a lot of industries. Most typically you'd probably see a ratio of 1.1 or greater as being a threshold for identifying organizations healthy enough to meet those obligations—the annual principal and interest obligations—but still want to make sure that we cover this ratio and some of the elements that feed into it.

All right; let's take a step back, if that's all right then. We've got just a few minutes left on the webinar here and want to take a step back and return to some of the context here. The targets used in these measures are generally based on industry standards for determining a school's financial health. I'd say recognizing that standards within the charter school specific subsector are really just starting to, I guess I should say perhaps are in a fairly nascent stage. And they dictate—let's call it an initial rating for schools based on audited financial information.

- | | |
|---|---|
| <div style="background-color: orange; width: 10px; height: 100px; margin-bottom: 10px;"></div> <p>Targets</p> <ul style="list-style-type: none"> • Set based on model authorizer practices, charter school finance expertise, and industry standards • May be shifted in a particular state to accommodate for unique situations |  |
|---|---|

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That being said, you should be mindful of unique circumstances and state laws that may require modification

to the framework. I recognize many of you on this webinar are not authorizers, and you may see other useful ways in which you could use this information—be it for internal management, perhaps for [the] development of a dashboard or a scorecard for board reporting purposes or whatever it might be. But at its core the framework does provide means to evaluate whether current and continued investment in a school is a responsible and, I'd say, a beneficial use of public funds. So [if there are] any modifications, I guess I'd just suggest should be made with that purpose in mind.

Back to our case study. Just as we step back and think about what we learned about the Academy for Technical Education here, let's think about—"Does the school meet the standards?" I'm not going to go to a poll on this. I'm just going to reflect on it for just a minute here. "What have the schools [inaudible]?" The way I want to do that is—really the big question, What does all this add up to, right?

First off, I'd say the schools that fail the near-term indicators are at a high risk for financial distress or closure. There we go.

As such, they require additional monitoring and/or corrective action, so authorizers or other individuals should determine the severity of the problem, assess changes in the school's financial performance and health since the date of the audited financial statements or whatever data you're using, and require that the school take actions to stabilize that financial position.

Now, schools may be failing on the sustainability indicators for multiple reasons. They may be trending toward financial distress or they could have a sound rationale for failing to meet the standards in a given year. For example, a school that's otherwise, let's say, financially sound could fail to meet the cash flow measure if it made a one-time large capital investment. So authorizers or other stakeholders need to determine if the school's failure to meet the standard

Case Study

- Does the school meet the standards?
- What does the school's ratings indicate?
- Given the ratings, what actions should the authorizer take?



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If a school gets a yellow or red, is it in trouble?

- Failure to meet the standards MAY indicate that a school:
 - Is in immediate financial distress
 - Is financially trending negatively
 - Both
 - Neither: In some cases, the school may have red or yellow flags due to a strategic financial decision.



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was a result of a one-time event or if it represents an underlying structural problem with the school's financial performance. To this end, authorizers should collect and analyze additional information from the school and perform more in-depth due diligence.

All that being said, within the context of our framework, the position and the guidance here is that if a school receives two or more ratings of does not meet standard or one or more ratings of falls far below standard, based again on the initial analysis of the school's audited financial statements, we've recommended that authorizers should conduct a more comprehensive review of the school's finances. Additional intervention: It could be in the form of a notice of unsatisfactory performance, increased monitoring, [inaudible] your financial check-ins, or requests for additional information.

So, you know, and really in conducting additional analysis, you should consider requesting current financial information in addition to the audited information. Examples include a current balance sheet, budget variance report, current cash flow projection—things of that nature. Or you may want to request additional information that's specific to whatever standard the school perhaps failed to meet.

Again, the point here is that the framework provides an objective starting point for a conversation about a school's financial health. In the corresponding guidance, it includes examples of additional information that you could request as part of a comprehensive review and also what to look for in the additional data to identify signs of progress toward a more financial ongoing basis.

With that, I know we have only a few minutes left here, and I was hoping that Whitney could close out with a couple of contextual comments bringing it all back to the context of financial performance and its impact on high-stakes decision making.

Action Steps

1. Collect current information:
 - Updated financial statements
 - Budget variance reports
 - Updated budget projections
2. Request specific reports related to the school's area(s) of weakness
3. Request explanations for the area(s) of weakness and strategies used to ensure financial stability
4. Analyze monitoring data to determine need for ongoing monitoring

 naCSA

Should I be looking at anything other than the audit during the year?

- Quarterly reports, including:
 - Income statement and balance sheet showing year-to-date actual, year-to-date budget, variance, and year-end budget
 - Year-to-date statement of cash flows and cash flow projection through year end
- More frequent and/or targeted reports for schools with financial issues

Note that unaudited data is generally done on a cash or modified accrual basis.

 naCSA

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WHITNEY SPALDING SPENCER:

Yes, I want to talk—this largely comes from an authorizer perspective—but I think it’s helpful for folks who are involved more at the school level to think about, “How would my authorizer use this; how would they judge me based on this information?”

So just a few key points here. I’d say, number one, if you’re an authorizer evaluating a charter school, academic performance is going to be the primary driver for your decision making. Financial performance is important, and schools should be financially healthy. But, number one, an authorizer needs to see if the school is performing academically. If they’re not, they could be cash flush and be doing great financially. That doesn’t mean that they should continue to operate as a charter school. If they’re teaching kids, we have a serious problem.

What we’ve seen is often that schools that don’t have money—that aren’t performing well financially—are going to end up closing themselves. We think it’s very important for an authorizer to be tracking a school’s finances, letting them know when they’re not meeting the standards and when they think there’s a concern, asking them to come up with plans to become financially healthier. But at the same time, it’s not often that an authorizer has to say, “You’re doing great academically, you’re doing great organizationally, but we’re going to close you just because you didn’t quite meet some of those financial standards.” For the most part, if a school’s really struggling financially, they’ll either close themselves or the authorizer might close them just shy of that point so that there’s less disruption in the school.

The next is that authorizers should be on their toes and so, you know, just that it doesn’t matter. The authorizer really needs to be tracking the school’s financial performance closely so that they’re very aware if a school is trending negatively, headed toward the point where they might actually run out of money. The authorizer needs to be on their toes and ready to help that school with a close out, if

How does financial performance impact high-stakes decision making?

- Academic performance is the primary driver
- Schools without money close themselves
- Authorizers should be on their toes
- Death by a thousand cuts



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necessary. Obviously, throughout the process they should be letting schools know how they're doing so that schools are very aware that, hey, I'm headed to a bad place right now. And if the school ultimately does have to close, that the authorizer is prepared to help transition those students and the assets.

But in terms of thinking about the situation where a school is great academically and struggling a little financially, as I said, most of the time an authorizer is not going to move for revocation for that. However, if a school is not doing great academically, not doing great financially, not doing great organizationally, it can sort of be part of death by a thousand cuts. So it just becomes yet another reason why perhaps the school should no longer have a charter and might be considered for nonrenewal or revocation.

So just kind of thinking about the big picture. As Ben mentioned earlier, what happens when a school has yellow or red flags, they get does not meet standard, [or] they get falls far below standard, some authorizers we've worked with that we've met with their schools and the schools say, "Oh my gosh. I got a red. Does that mean that the authorizer is going to close me this year?" And that's where we say it's not, that's not generally what we're looking at. Most of the time unless a school is just completely broke to the point that they're not going to be able to continue quality operations, it's only a piece of the picture in decision making. So just wanted to make sure that was clear because it's something we certainly heard a lot from schools, is this concern that we might not make every, meet standard on every measure, but that isn't always uncommon.

I think we are actually at time, and I know I've been watching the chat box, and there have been a lot of really great questions. I think what we're going to do and, Ben, correct me if I'm wrong, is we can probably respond to some of these in writing and send an e-mail out to everybody who attend[ed] the webinar so that you can hear our responses on this. Does that work, Ben?

BEN AASE:

Yeah. No, I love all the questions. And I'd like to make sure we can address them in some way, so I'd like to assemble a little team here. We'll compile those and get some written responses distributed. I'm also thinking also we could include some, point you toward hopefully some helpful resources to wrestle through some of these. I appreciate the amount of limited dialogue we were able to get today but would like to commit to doing that.

WHITNEY SPALDING SPENCER:

Great. Thank you everybody for participating in the webinar. As I see many of you are already responding, we have put up a survey question just to see how did we do today, did you learn something, do you feel like you know more analyzing and monitoring charter school finance? We hope you do, but we would love your feedback, so that we can be more effective whenever we're training people in the future.



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TAMMIE KNIGHTS:

And I want to thank Ben and Whitney for taking their time today to share this resource with us, and we will be posting the webinar on the National Charter School Resource Center website—for folks who want to share this with other people—by the end of the week, as well as sending out the e-mail again to invite you to reach out to NACSA to get all of the documents. With that said, we also have an additional survey that we hope that you will complete before you go to help inform us in terms of how to provide the best quality resources for you.

BEN AASE:

Thank you everybody who participated.